

**SUPREME COURT OF THE UNITED STATES**

**OCTOBER TERM, 1942**

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**No. 472**

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**CLOVER SPLINT COAL CO., INC.,**

*Petitioner,*

*vs.*

**COMMISSIONER OF INTERNAL REVENUE.**

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**PETITION FOR A WRIT OF CERTIORARI TO THE  
UNITED STATES CIRCUIT COURT OF APPEALS  
FOR THE THIRD CIRCUIT AND BRIEF IN SUP-  
PORT THEREOF.**

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# INDEX.

## SUBJECT INDEX.

	Page
Petition for writ of certiorari.....	1
Opinions below (record).....	2
Jurisdiction.....	2
Statute involved.....	2
Statement of the case.....	4
Questions presented and errors urged.....	8
Reasons relied on for the allowance of the writ....	9
Brief in support of petition for writ of certiorari.....	13
Statement.....	13
Argument.....	13
Summary of argument.....	13
Issue under Sec. 26(c) (1) of the Revenue Act of 1936.....	15
Issue under Sec. 26(c) (2) of the Revenue Act of 1936.....	26
Conclusion.....	29

## TABLE OF CASES CITED.

<i>Commissioner v. Dashiell</i> (C. C. A. 7th), 100 Fed. (2d) 625.....	20
<i>Constantine v. United States</i> (C. C. A. 5th), 75 Fed. (2d) 928, affirmed 296 U. S. 287, 80 L. Ed. 233.....	25
<i>Farmers Loan and Trust Co. v. Minnesota</i> , 280 U. S. 204, 74 L. Ed. 371.....	25
<i>Gregory v. Helvering</i> , 293 U. S. 465, 79 L. Ed. 596.....	20
<i>Helvering v. Elkhorn Coal Co.</i> , (C. C. A. 4th) 95 Fed. (2d) 732.....	20
<i>Helvering v. Security Savings &amp; Commercial Bank</i> , (C. C. A. 4th) 72 Fed. (2d) 874.....	20
<i>Helvering v. Northwest Steel Rolling Mills</i> , 311 U. S. 46, 85 L. Ed. 29.....	8, 21
<i>Higgins v. Smith</i> , 308 U. S. 473, 84 L. Ed. 406.....	19
<i>Michigan Silica Company v. Commissioner</i> , (C. C. A. 6th), 124 Fed. (2d) 397, affirming 41 B. T. A. 511... 11, 15, 28	

	Page
<i>Old Colony Railroad Company v. Commissioner</i> , 284 U. S. 552, 76 L. Ed. 484 (560).....	22
<i>Saginaw and Manistee Lumber Co. v. Commissioner</i> , 45 B. T. A. 780.....	11, 29
<i>Shoenberg v. Commissioner</i> , (C. C. A. 8th) 77 Fed. (2d) 446.....	20

## STATUTE CITED.

Chapter 229, 43 Stat. 936, 28 U. S. C. A. 347.....	2
Revenue Act of 1936, Section 22(c).....	11
Revenue Act of 1936, Section 26(c) (1) and (c) (2)...	2, 3, 8, 9 11, 15

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*To the Honorables the Chief Justice and the Associate Jus-  
tices of the Supreme Court of the United States:*

Your petitioner, Clover Splint Coal Co., Inc., a corpora-  
tion, respectfully prays that a writ of certiorari issue to  
review the final order and decision of the United States Cir-  
cuit Court of Appeals for the Third Circuit, entered on the  
19th day of August, 1942, affirming an order of the United  
States Board of Tax Appeals, finding that there was a  
deficiency against this petitioner in income tax for the cal-

endar year 1937 in the amount of \$12,468.20. An order staying the mandate until October 31, 1942, has been entered by the Circuit Court of Appeals.

### **Opinions Below.**

(Record.)

There is presented with this petition a printed record consisting of the Appendix to the brief of the petitioner filed in the Court of Appeals and the proceedings in that Court. References to the record hereinafter set forth are to such printed record. The contents of the printed record were stipulated and agreed to by counsel, subject to the approval of the Court (R. 40), it being further stipulated that the entire transcript of the record in the office of the Clerk of the Court of Appeals should be filed in this Court, which was done, and that either party may refer to any portions of the certified transcript not included in the printed record accompanying this petition. The opinion of the Board of Tax Appeals appears in the printed record (pp. 24 to 29, incl.), preceded by findings of fact (pp. 15-23, incl.), and the opinion of the Circuit Court of Appeals (not yet officially reported) appears in the printed record (pp. 33 to 39, incl.).

### **Jurisdiction.**

The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925 (Chap. 229, 43 Stat. 936, 28 U. S. C. A. 347).

### **Statute Involved.**

The issues involve the construction, and application to the facts in this case, of Section 26, Subdivisions (c)(1)

and (c) (2) of the Act of Congress, approved June 22, 1936, known as the Revenue Act of 1936, which are as follows:

“SEC. 26. CREDITS OF CORPORATIONS.

“In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

. . . . .

“(c) Contracts Restricting Payment of Dividends.

“(1) Prohibition on Payment of Dividends.—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

“(2) Disposition of Profits of Taxable Year.—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to

pay or set aside such percentage of earnings and profits. As used in this paragraph, the word 'debt' does not include a debt incurred after April 30, 1936."

### **Statement of the Case.**

The material facts are summarized in the opinion of the Circuit Court of Appeals (R. 33-36), as well as somewhat more in detail in the findings of fact of the Board (R. 15-23). As stated by the court, there is no dispute of fact. In the proceeding before the Board, in addition to the issue here present, there was an issue with respect to depletion which was resolved for the most part in favor of the petitioner, and no appeal being taken by either party, that issue is not now before the court, the sole remaining issue being as to the so-called undistributed profits tax.

The Clover Splint Coal Company, Inc., a West Virginia corporation, the petitioner, which keeps its books in Pennsylvania, and accordingly filed its income tax returns with the Collector of the 23rd District of Pennsylvania within the Third Circuit, was engaged in the production and mining of coal from a leasehold in Kentucky. In 1929 it executed a mortgage to secure an issue of notes maturing May 1, 1936, the mortgage providing that the petitioner should deposit with the corporate trustee twenty cents for each ton of coal mined at such times as the aggregate of the outstanding notes should be less than \$300,000, twenty-five cents when the aggregate notes exceeded that sum. The mortgage was subsequently modified by three indentures, the last being on August 24, 1934, which modifications relieved the petitioner of some of its more immediate obligations under the mortgage, the net effect of the amendments being to extend the maturity of the notes to May 1, 1941, to relieve petitioner from making sinking fund payments for a period which expired on November 1, 1936, at which date sinking fund requirements became in full force



and effect and were in full force and effect throughout the year 1937. (See Statement of Facts in opinion below (R. 34-36).)

These modifications, all of which antedated May 1, 1936, were conditioned that the petitioner should make no payments in the nature of dividends except it should have previously paid to the Corporate Trustee an amount that would have been equal to the original sinking fund requirements, or should have acquired, by cancellation, mortgage notes in an equivalent amount, and were further conditioned that the petitioner should make no payments in the nature of dividends to its stockholders except that it should have previously paid all interest coupons.

It was conceded, and there is no dispute, that this was a valid restrictive contract inhibiting the payment of dividends until the conditions were met, and that it was in effect during the first ten months of 1937 (R. 36). Accordingly, at the commencement of the year 1937 petitioner was subject to three binding inhibitions or requirements under a valid restrictive contract antedating May 1, 1936:

(a) It was required currently to pay the Corporate Trustee twenty cents (twenty-five cents) for each net ton of coal mined.

(b) It was inhibited specifically from the payment of any dividend until it should have previously paid an amount equal to the original sinking fund requirements.

(c) It was specifically forbidden from making any payment of dividends except that it should have previously paid all interest coupons on the outstanding notes and interest upon the coupons as provided in the modified mortgage.

It is specifically stipulated (R. 11):

"At the commencement of the year 1937, and at all times prior thereto, and during said year until the

release of said mortgage, petitioner did not, and could not, make and did not have funds, or income, either accumulated or accrued, sufficient to make, the various payments required to be made by the various paper writings set out in subdivision (a) to (e) inclusive of this paragraph as a condition precedent to the payment of any dividends."

It is further stipulated (R. 11):

"All of the foregoing paper writings hereinbefore recited were executed and effective prior to the 1st day of May, 1936, and upon said day, and at all times thereafter, petitioner had not met, and was unable to meet the conditions therein set out, precedent to the payment of dividends."

For the year 1934, petitioner had a net loss of \$100,728.38; for 1935 it had a net loss of \$88,218.14; and for 1936 a net income of \$198.47 (R. 19). It is stipulated (R. 12) that on December 31, 1936, it had a deficit, in accordance with tax returns and adjustments made by the Commissioner, of \$435,614.86, and a deficit of \$372,958.36 on December 31, 1937. For the year 1937 its net income, exclusive of any allowance for depletion, was \$70,027.35, whereof \$49,611.46 was applicable to the period from January 1 to October 31, 1937, both inclusive, and \$20,415.89 to the last two months of the year. Its net income for 1937, after allowance for depletion as determined by the Board, was \$51,759.95 (R. 35). In 1937 its gross sales of coal amounted to \$1,014,098.24 (R. 19).

During the first ten months of 1937 it made payments in varying amounts to the Corporate Trustee in the aggregate of \$71,868.79, it being stipulated that such payments were made "as required by the mortgage" and the modifications thereof (R. 13). These payments were slightly more than its total net income for the whole year, exclusive of any

allowance for depletion, the latter being, as above set forth, \$70,027.35.

It is stated in the opinion of the court below that the petitioner has not shown, however, that the cash which it paid to the Trustee was actually the proceeds of earnings and profits. It is, of course, true that the earnings, as well as these payments, passed in the usual course of business through the credits and debits of banks, and neither in the payments, nor in the receipts of earnings and profits, was there a literal reduction to identical specie, but the court certainly does not mean that such would be necessary. It is most respectfully submitted that the court below, in stating that the sources of these payments has not been shown to be the proceeds or earnings or profits, has overlooked the stipulation not only that they were made "as required by the mortgage" (R. 13), but the language of the stipulation appearing on page 11 of the record, heretofore quoted, shows that until the release of the mortgage, petitioner did not, and could not make, did not have funds or income, either accumulated or accrued, sufficient to make, the various payments required. Such was intended to be, and is a comprehensive negation of the *existence* or *possibility* of any extraneous accumulated funds. It is stipulated that petitioner made these payments "as required by the mortgage," that is, the sinking fund provisions which were in full effect.

In addition to these sums so paid during the first ten months of the year there remained due as of November 1, 1937, under the mortgage as amended \$26,335.98, which sum was paid by the petitioner on October 20, 1937, to the Corporate Trustee, and the two said sums aggregating (together with a small balance in the hands of the Trustee) \$98,793.94 were disbursed in retirement of bonds and payment of interest (currently accrued and accrued in previous years), and the mortgage released on November 1, 1937

(R. 14). The mortgage was in full effect until November 1, 1937, and the payments aggregating \$98,164.77 were actually and irrevocably made prior to that date (R. 14).

Petitioner declared dividends attributable to that part of its net income received in the last two months of the year, but took the position that the part of its net income accrued and received during the first ten months of the year (having been irrevocably paid out as above set forth prior to the release of the mortgage, and the latter having inhibited the payment of dividends), was subject to a credit under both subdivisions of Section 26(c) of the Act. The Commissioner, denying this contention, imposed the undistributed profits tax upon the whole of the net income for the year 1937, without reference to that part accrued, received and paid out prior to the release of the mortgage, although conceding the effective character of the mortgage until it was released.

Before the Board, petitioner urged that the statutory law of West Virginia forbade the payment of dividends in case of a corporation having a deficit such as that here stipulated, and the unconstitutionality of the Undistributed Profits Tax Law, but in view of *Helvering v. Northwest Steel Rolling Mills*, 311 U. S. 46, decided after the institution of this proceeding, these contentions are no longer urged.

#### **Questions Presented and Errors Urged.**

(1) Whether or not petitioner is entitled to a credit under Section 26(c)(1) of the Revenue Act of 1936, with respect of income accruing, received and distributed to the Trustee within the first ten months of 1937, prior to the release of the mortgage, it being affirmatively stipulated that prior to such release petitioner was unable to meet the requirements of the mortgage, as amended, specifically made con-

ditions precedent to the declaration of dividends. The denial of such credit by the court below is urged as error.

(2) Whether or not petitioner is entitled to a credit under Section 26(c) (2) of the Revenue Act of 1936 for the amounts distributed during the first ten months of 1937, as required by the mortgage, it being petitioner's contention that such sinking fund provisions and other provisions of the modified mortgage, expressly dealt with earnings and profits for the taxable year. The denial of such credit by the court below is urged as error.

#### **Reasons Relied On for the Allowance of the Writ.**

1. The Circuit Court of Appeals has decided an important question of Federal law which has not been, but should be, settled by this Court, in that—

(a) It has decided that the Undistributed Profits Tax Law is applicable to income for *all* of a taxable year, even though a valid restrictive contract be released during the year, and even though, prior to such release, income received has actually been irrevocably distributed, as required by such contract, upon a pre-existing debt.

(b) It has decided that for the purposes of the Undistributed Profits Tax the taxable year is an indivisible unit and that, even though a valid restrictive covenant be in effect during a portion of the year and income be distributed on prior debt, as required thereby, nevertheless, if such covenant be released in the course of the year, such release, in effect, is retroactive to the first of the taxable year, and, for purposes of undistributed profits tax, the status of all income for the year, even though actually distributed under the restrictive contract, is as though no restriction had been in effect.

(c) It has decided that the undistributed profits tax shall be based upon the net income at the end of the year, for the unit of the whole taxable year, arrived at as a matter of bookkeeping, rather than upon the actual status, ignoring the fact that a large part of the income in question has actually been distributed as required by a valid restrictive contract effective during a large part of the year.

(d) It has determined that the words of the statute "can be distributed" are to be interpreted from the viewpoint of the *book income* at the end of the year, ignoring that *actually* a large part of the income in question could not be distributed as dividends, because it had previously been distributed under a valid restrictive contract, which required such distribution, there being a stipulation that negatives the existence and possibility of extraneous income or accumulated funds from which such distributions, so required by the mortgage, could have been made.

The importance of this decision is apparent when it is noted that the same question is certainly involved in the case of every mortgage which requires, through sinking fund provisions or otherwise, the appropriation of current income to the satisfaction of prior secured debts and which mortgage is released during the current year. Generally, the question here involved affects every mortgage that was released or satisfied in a taxable year during the incidence of an undistributed profits tax, and affects the status of any distributions made in accordance with such mortgage. When it is noted that there were without question innumerable mortgages released or satisfied within taxable years during the incidence of the Undistributed Profits Tax Law, the wide effect of the decision below is seen.

2. The decision of the Circuit Court of Appeals is in substantial conflict with the decision of another Circuit Court of Appeals on the same matter, in that—

The mortgage here required a tonnage payment for each ton of coal mined. The Circuit Court of Appeals of the Third Circuit in the present instance has decided that such a provision does not deal with the disposition of earnings and profits within the meaning of Section 26(c)(2). The Circuit Court of Appeals of the Sixth Circuit, in *Michigan Silica Co. v. Commissioner*, 124 Fed. (2d) 397, affirming, per curiam, the Board of Tax Appeals in an opinion reported in 41 B.T.A. 511, held that a mortgage requiring a tonnage payment for each ton of product produced and sold dealt with earnings and profits. In the court below, it was sought to distinguish the *Michigan Silica Company* case on the ground that here the mortgage referred only to product mined, whereas there it dealt with the product produced and sold. It is submitted that such distinction is without substance. In any event, if coal were mined and unsold, certainly it would be required to be reflected in inventories, as otherwise true income could not be determined. (See Revenue Act of 1936, Section 22(c)). The sale of such coal would not affect taxable earnings or profits, if, as would be required, unsold coal were reflected in inventories. A sinking fund provision as to coal mined, disposes of earnings and profits as fully as though it specifically recited coal mined and sold. As a practical matter it could not be contemplated that a company would engage in current production without the sale of such current production, and in the present instance sales for the year in question exceeded one million dollars.

The Board in following the *Michigan Silica* case has not made this distinction, holding in *Saginaw & Manistee Lumber Co. v. Commissioner*, 45 B.T.A. 780, that a provision of a sinking fund for a unit payment of product sold or used was within Section 26(c)(2) of the Act, stating that although such payment was not specified to be made out of earnings and profits, it comes within the reasoning of the



*Michigan Silica* case. There is accordingly a substantial conflict between the decision of the Circuit Court of Appeals of the Third Circuit and the decision of the Circuit Court of Appeals of the Sixth Circuit.

WHEREFORE your petitioner respectfully prays that a writ of certiorari be issued out of, and under the seal of, this Honorable Court, directed to the Circuit Court of Appeals for the Third Circuit, commanding that court to certify and send to this Court for its review and determination, on a day certain to be therein named, a full and complete transcript of the record and all of the proceedings in the case numbered on its docket No. 8007, and entitled "*Clover Splint Coal Co., Inc., Petitioner, Appellant, v. Commissioner of Internal Revenue, Respondent, Appellee*", and that the judgment of the Circuit Court of Appeals for the Third Circuit entered on August 19, 1942, may be reversed and the decision of the Board of Tax Appeals entered on June 15, 1942, may be reversed and this petitioner held not liable for the tax in question and that this petitioner may have such other and further relief in the premises as to this Court may seem proper.

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Coal Co., Inc., Petitioner.*







## **BRIEF IN SUPPORT OF PETITION FOR WRIT OF CERTIORARI.**

### **Statement.**

Reference to the opinion below, a statement of the grounds upon which the jurisdiction of the Court is invoked, and a statement of the case, under appropriate headings, are set out in the foregoing petition, and to avoid duplication are not repeated here.

### **ARGUMENT.**

#### **Summary of Argument.**

For the first ten months of the taxable year, petitioner was subject to a mortgage, as amended, concededly a valid restrictive covenant under Section 26 of the Revenue Act of 1936, whereby—

(a) It was specifically forbidden to declare dividends until it had paid large sums of accrued interest and sinking fund obligations under the original mortgage, and

(b) It was currently required to make a sinking fund payment to the mortgage trustee for every ton of coal mined.

As required by the mortgage, it made payments in varying amounts during the first ten months of the taxable year, of an aggregate in excess of its net income. Such constituted an irrevocable payment of its net income, as it is stipulated that, prior to the release of the mortgage it did not, and could not, make and did not have funds or income, either accumulated or accrued, sufficient to make the payments which were required as a condition precedent to any dividends,

The mortgage was released on November 1 of the taxable year and, accordingly, for the last two months thereof no contractual inhibition as to dividends was currently in effect.

Such circumstance does not justify, however, the imposition of an undistributed profits tax upon a basis of the whole net income for the year as disclosed by the books, because—

(a) Such is only a book income, the actual income, and the source of payment of any dividend, having been previously distributed by contractual compulsion.

(b) The words “can be distributed” occurring in the statute will be interpreted according to their natural and ordinary meaning and not according to theoretical bookkeeping concepts.

(c) The statute will be interpreted so far as possible to avoid unjust or unreasonable consequences. To deny a credit with respect of income so distributed would lead to such consequences because—

1. There would be a heavy penalty upon this taxpayer in relation to other taxpayers who have had restrictive contracts released at a more favorable time in a taxable year, or were upon a more favorable fiscal year basis—fortuitous circumstances wholly disassociated from the realities of tax status.

2. To deny such credit is in effect to make the release of November 1 retroactive to the first of the year, thereby distorting the realities of the situation, and depriving it of any effect during the year, even though actually taxpayer was bound to act under its requirements for ten months of that period.

The sinking fund requirement that a tonnage payment be made for each ton of coal mined dealt with earnings and profits, and payments made thereunder entitled petitioner to a credit under Section 36(c) (2) of the Act of 1936. Such

is true even though the mortgage referred to "coal mined," and not "coal mined and sold" because—

(a) If coal were mined and not sold, the value of such unsold coal would go into inventories, and would be included in, and affect, earnings and profits to the same extent, and in the same manner, as if sold, and

(b) As a matter of natural interpretation, and practical necessity, the mortgage contemplates sale, as well as mining of product, and in the year in question there were more than \$1,000,000 in sales.

There is accordingly an irreconcilable conflict between the decision of the Circuit Court of Appeals in this case and that of the Circuit Court of Appeals of the Sixth Circuit in *Michigan Silica Company v. Commissioner*, 124 Fed. (2d) 397.

#### **Issue Under Section 26(c)(1) of the Revenue Act of 1936.**

Section 26(c) (1), in fixing the basis for credit against the undistributed profits tax refers to amounts "which can be distributed," without violating a provision of a written contract expressly dealing with the payment of dividends. Section 26(c) (2) gives credit for the portion of the earnings and profits of the taxable year, which is required by a restrictive contract, to be paid within the taxable year in discharge of a prior debt. There is here no question but that the mortgage expressly referred to dividends, and it was conceded in the court below by respondent, and doubtless will be conceded, that such mortgage as amended was a valid and restrictive contract until it was released. It is stipulated that at no time until such release did the petitioner have any funds or income, either accumulated or accrued, sufficient to make the various payments required by the mortgage as a condition precedent to the payment of any dividends.

There is likewise no dispute that the sinking fund provisions of the mortgage were in effect during the year 1937, and that there was paid under them in varying amounts to the Corporate Trustee the sum of \$71,868.79 (R. 13), a sum in excess of the net income. In addition to these payments, \$26,335.98 was also paid to the Trustee prior to November 1, 1937 (R. 13). These payments are stipulated as having been made "as required" by the mortgage and modifications thereof (R. 13).

The Court below states (R. 37) that the taxpayer has not shown that these payments were actually the proceeds of earnings or profits, and that at least to some extent they must have been made from other sources, as the aggregate payments exceed net income. With every deference to the Court, it is respectfully submitted that it failed to give effect to that part of the stipulation appearing in the record, on page 11, to the effect that until the release of the mortgage the petitioner *did not*, and *could not*, make, and did not have *funds or income*, either *accumulated or accrued*, sufficient to make the payments required as conditions precedent to declaration of dividends. These payments were made under compulsion of the modified mortgage, and the stipulation is a comprehensive negation of the existence or possibility of any extraneous funds other than income, or other funds beyond the payments actually made. It would, of course, have been possible to have stipulated specifically that petitioner did not have funds from extraneous sources which would have permitted it to make these payments, thus leaving income intact, such as from capital contributions, reserves, or the like, and such would certainly have been the fact, but it would be impossible to embrace all the theoretical sources from which a corporation might have received money. It might receive insurance proceeds upon the life of an officer; it might be awarded damages in a tort action; it might conceivably find

money. It would be impossible to stipulate against every possibility of this kind otherwise than in general terms, and here the stipulation is in the most definite and comprehensive terms that it did not have "funds or income," either accumulated or accrued, of an extraneous character. The stipulation was intended as a comprehensive negation—and, it is respectfully submitted that it is such—of the existence or possibility of any extraneous funds. It follows that the payments that were made to the Trustee represented the receipts of the current income to the extent of that income, and represent all other available money. Otherwise, the comprehensive stipulation of the absence of any other funds or income would be nugatory. Therefore, counsel respectfully submit that it is undeniable that the payments made to the Trustee were made (a) under the compulsion of the mortgage, and (b) those payments necessarily included the net income received during the first ten months of 1937.

There is no question that such payments were irrevocably and finally made, it being stipulated (R. 14) that these funds were all distributed by the Trustee, as required by the mortgage. In passing, it may be noted that the Circuit Court of Appeals states (R. 37) that the sinking fund payments were for the purpose of reducing taxpayer's debt; that they were capital expenditures, were not expense payments which would have been deductible from income, the Court evidently overlooking (R. 14) that these payments were applied by the Trustee to the extent of \$42,840.00 for the retirement of bonds, \$39,171.10 for interest accrued prior to 1937, and \$16,782.84 accrued during the year 1937. Very much more than half thereof were for interest payments which were either deductible in the current year or accrued and unpaid in prior years. It cannot be gainsaid that actually the income for the first ten months upon the date of the release of the mortgage

had passed out of the treasury of the corporation, and had actually been distributed under contractual compulsion. Is this income, previously distributed, such as "can be distributed" when the mortgage is released? It is true that, as a matter of bookkeeping, a net income appears on the books of the corporation at the end of the year, but such is merely a book entry. The actual fact is that the money represented by that income has previously been distributed.

The Circuit Court of Appeals bases its decision upon the accounting concept (R. 37, 38) that the books showed a net income at the end of the year, regardless of the payments previously made, that the Court is concerned only with the question whether taxpayer was contractually permitted to distribute profits at any time during the year 1937 and, because during the last two months of the year there was no contractual inhibition and the books for the year showed a net income, taxpayer theoretically was able to declare a dividend. Nowhere in the record is it shown that as a practical matter it could have declared a dividend. When it was relieved from its contractual obligation, its income had been distributed under the requirements of the contractual obligation. It had an enormous deficit both at the beginning and at the end of the year, the latter, even reduced by its net income for 1937, amounting to \$372,958.36 (R. p. 12). If such a corporation had been able to go out and borrow enough money to declare a dividend equivalent to its whole net income for the year, a supposition most unlikely, certainly legally it was not required so to do. A dividend is a very real thing: it is not a matter of bookkeeping. It must be paid from an actual source; it cannot be paid by book entries. Here the only source from which such dividend could be paid had been wiped out under the contract before its release. There was positively and literally no way by which a dividend could actually have been paid.



The inability of the taxpayer to pay the dividends cannot be denied by the *actuality* of the situation. Certainly, Congress when it used the words in the statute, "can be distributed," must have meant the plain, common sense, and actual meaning of those words. The purpose behind the undistributed profits tax was to require the distribution of available earnings by dividends that would be taxable to the recipient stockholders, and certainly the situation of the taxpayer is not within the contemplation of Congress. A corporation with a huge deficit, which actually distributed under contractual compulsion its income as received, with absolutely no funds in its treasury which would permit the distribution of a dividend, certainly is not within the intent of Congress as the subject of taxation. Its situation was beyond the purview of the statute, which surely did not have the purpose of requiring through theoretical book-keeping concepts, that which was practically, actually and realistically impossible. To say, under such circumstances, that the petitioner could have paid a dividend out of earnings that had previously been disbursed, and thereby obtain a dividend-paid credit, or to say that the subsequent release could affect a prior, actual and irrevocable payment, is to be utterly unrealistic. Perhaps the most significant development of tax law in the last few years has been the most commendable trend, evidenced by both the decisions of the Courts and the Board, to regard a tax situation from the actual and practical viewpoint, and not upon mere theories of accountancy. This trend has been forcibly shown by Mr. Justice Reed, speaking for this Court, in the recent opinion of *Higgins v. Smith*, 308 U. S. 473, 84 L. ed. 406, in which he said (Italics ours):

"There is no illusion about the payment of a tax exaction. Each tax, according to a legislative plan, raises funds to carry on government. The purpose here is to tax earnings and profits less expenses and

losses. *If one or the other factor in any calculation is unreal, it distorts the liability of the particular taxpayer to the detriment or advantage of the entire tax-paying group.*"

It would be impossible to visualize a situation more distorted from actuality than to impose a tax upon so-called undistributed profits, which profits actually had been irrevocably paid out under the requirements of a pre-existing mortgage, or to assume that a taxpayer should have declared dividends in the last two months of a taxable year out of funds that were no longer in its treasury and could not have been retained in such treasury. As said in *Shoenberg v. Commissioner* (C. C. A. 8th), 77 Fed. (2d) 446, "taxation is concerned with realities." How far the courts go in looking to the actual situation in tax matters, even where it is necessary to brush aside legal technicalities and concepts (such is not here necessary) appears from the following cases:

*Gregory v. Helvering*, 293 U. S. 465;  
*Helvering v. Security Savings & Commercial Bank*, 72 Fed. (2d) 874 (C. C. A. 4th);  
*Helvering v. Elkhorn Coal Co.*, 95 Fed. (2d) 732, (C. C. A. 4th);  
*Commissioner v. Dashiell*, 100 Fed. (2d) 625, (C. C. A. 7th).

The language of Section 26(c) (1) refers to "amounts which can be distributed within the taxable year as dividends," etc. The stipulation, almost in the same words, negatives such ability. The restrictive writings were executed and effective prior to the 1st day of May, 1934, and (*italics ours*) "upon said day, and at all times thereafter, petitioner had not met, and *was unable* to meet, the conditions therein set out, precedent to the payment of dividends." (R. 11.) Of course, the complete correspondence between the verb "can" and the expression "is able,"

with its negative "unable," is apparent. Here the stipulation specifically parallels the words of the statute in showing an inability to make a distribution, which the statute provides "can be distributed" before the tax is imposable. Words in a statute must, of course, be given their ordinary meaning unless some technical definition be provided. This Court in *Helvering v. Northwest Steel Rolling Mills*, 311 U. S. 46, committed itself to the natural or common sense interpretation of the words of the statute. There the taxpayer was forbidden by the law of the state of its incorporation to declare a dividend because of a pre-existing deficit. The question was whether such legal inhibition was to be read into the corporate charter, and the latter accordingly interpreted as a written contract prohibiting dividend payments. The Court recognized that in certain circumstances a corporate charter had been judicially construed as a contract and that it had been said that the act of incorporation was a contract between the state and the stockholders. However, the Court in giving the natural, common sense interpretation of the statute said, in the course of the opinion:

"The natural impression conveyed by the words 'written contract executed by the corporation' is that an explicit understanding has been reached, reduced to writing, signed and delivered."

In the present instance, it conclusively appears that, as a matter of reality, petitioner could not have distributed a dividend measured by its total income because of prior distribution under the requirements of the mortgage. It had nothing from which such dividend could be paid. Certainly the "natural" meaning of the words "can be distributed" must be attributed to Congress, which was certainly dealing with actual ability, not a theoretical bookkeeping status.

As stated by this Court in *Old Colony Railroad Co. v. Commissioner*, 284 U. S. 552, 76 L. Ed. 484, on page 560 of the opinion:

“ ‘The legislature must be presumed to use words in their known and ordinary signification.’ *Levy v. M’Cartee*, 6 Pet. 102, 110, 8 L. ed. 334, 337. ‘The popular or received import of words furnishes the general rule for the interpretation of public laws.’ *Maillard v. Lawrence*, 16 How. 251, 261, 14 L. ed. 925, 930. And see *United States v. Buffalo Natural Gas Fuel Co.*, 172 U. S. 339, 341, 43 L. ed. 469, 470, 19 S. Ct. 200; *United States v. First Nat. Bank*, 234 U. S. 245, 258, 58 L. ed. 1298, 1303, 34 S. Ct. 846; *Caminetti v. United States*, 242 U. S. 470, 485, 61 L. ed. 442, 452, L. R. A. 1917F, 502, 37 S. Ct. 192, Ann. Cas. 1917B, 1168. As was said in *Lynch v. Alworth-Stephens Co.*, 267 U. S. 364, 370, 69 L. ed. 660, 662, 45 S. Ct. 274, ‘the plain, obvious and rational meaning of a statute is always to be preferred to any curious, narrow, hidden sense that nothing but the exigency of a hard case and ingenuity and study of an acute and powerful intellect would discover.’ This rule is applied to taxing acts: *De Ganay v. Lederer*, 250 U. S. 376, 381, 63 L. ed. 1042, 1044, 39 S. Ct. 524.”

It was argued below and the position was adopted by the Circuit Court of Appeals that if at any time during the taxable year the taxpayer was free from the contractual inhibition as to any dividends—and it was free during the last two months—then under the statute it should not be given credit for money paid out during the period when it was under contractual inhibitions and requirements, and that any actual inability to declare a dividend in the last two months of the year arose from the prior use of money and not from a contractual inhibition. It is respectfully submitted as inescapable that such prior use of money was, and such is stipulated, as required by the contract. It follows as the night the day that inability to declare a divi-

dend in the last two months arose from the restricted contract because the actual distribution of the income had been made under its requirements. To give retroactive effect to the release of November 1, 1937, so as to make it operative during all of the year and to remove from its protective provisions the whole income for the year is not only to close one's eyes to actuality, but to deny any effect to the admittedly valid restrictive contract during the period in which it was in effect.

It will perhaps make for clarity, if it be visualized that the petitioner, instead of being relieved by the voluntary exchange of notes for stock by the noteholders, had obtained release of the mortgage through the complete satisfaction of the indebtedness secured. There have been innumerable mortgages satisfied through payments to the trustee under restrictive contracts, such as that admittedly here present during the first ten months of the year. In virtually all of such instances the mortgage is satisfied during a taxable year. It would be improbable that such satisfaction would happen exactly at the end of a year. Doubtless in 1937 there were countless mortgages satisfied during the course of the year through application of sinking fund payments, parts of which were made during that year. Shall it be said that in every such instance the restrictive covenants of a mortgage, however stringent they might be, become ineffective as of the first of the year? Every corporation, unless it happened by a long chance to satisfy its mortgage at the exact end of, or just beyond the taxable year, would be heavily penalized during the years of the incidence of the undistributed profits tax law. Assume a corporation prior to May 1, 1936, had borrowed money under a mortgage which required it to apply all of its current net income to the satisfaction of the debt, forbidding dividends until the debt was so satisfied—provisions within both sections of the statute as was here the case—and the money was so

applied, with the result that on December 20, 1937, the debt was finally paid and the mortgage released. Could such corporation have declared a dividend of all of its net income for 1937? The voluntary release here by the noteholders on November 1, 1937, has precisely the same effect as though the mortgage were satisfied on that date.

Let us assume two mortgages with valid restrictive covenants, both of which required all income to be applied to the secured indebtedness and that one happened to be satisfied by application of such income on December 15, 1937, the other on January 15, 1938. Under the holding in this case there would be a tremendous difference in tax. Assume also that the taxpayer, as might very well have been the case, instead of being on a calendar year basis had been on a fiscal year basis ending on October 31. Taxpayer during the first ten months of 1937 could doubtless have obtained permission to go upon such a fiscal year basis. Such would be a circumstance entirely fortuitous and wholly unrelated to the realities of the tax situation here present, which would actually have been the same. However, under the decision of the Circuit Court of Appeals there would have been then no question that taxpayer would have received the protection of the restrictive contract, and there would have been no deficiency.

Sections 26(c)(1) and (2) of the Act give credits in reduction of the tax imposed by Section 14. These subdivisions, as counsel most fully admit, are subject to strict construction. Deductions and credits as against a generally imposed tax are matters of legislative grace, and the statutes conferring them should be strictly construed. However, this is not a question of strict or liberal construction. It is a question whether the words of the statute "can be distributed" and similar words are to be given their ordinary, natural meaning or whether they are to be construed without relation to actuality upon theoretical bookkeeping

concepts. As heretofore stated, this Court in *Northwest Steel Rolling Mills* has committed itself to the "natural" interpretation of Section 26(c)(1).

In no event would the rule of strict construction, if it were involved, ever be extended to justify an inherently unjust and unreasonable interpretation or one leading to unjust results, such being said with entire deference to the position taken by counsel for respondent and to the decision of the lower court. Unreasonable interpretations of a statute are to be avoided, as are, so far as possible, unjust consequences.

*Constantine v. United States* (C. C. A. 5th), 75 Fed. (2d) 928, affirmed, 296 U. S. 287, 80 L. Ed. 233;  
*Farmers Loan & Trust Co. v. Minnesota*, 280 U. S. 204, 74 L. Ed. 371, 65 A. L. R. 1000.

As said by this Court in *United States v. Kirby*, 7 Wall. 482, 19 L. Ed. 278:

"All laws should receive a sensible construction. General terms should be so limited in their application as not to lead to injustice, oppression, or an absurd consequence."

See also *Oates v. First National Bank*, 100 U. S. 239, 25 L. Ed. 580; *United States v. Chase Securities Co.*, 24 F. (2d) 500, certiorari denied, 277 U. S. 600.

If the statute were given the interpretation of the Circuit Court of Appeals, it is obvious:

(1) Actually the taxpayer could not have distributed a dividend equivalent to its total income for 1937, because of the sums which it had irrevocably distributed in accordance with the restrictive contract, when the latter was in effect during the first ten months of the year;

(2) To impose a tax upon its theoretical book income because it had failed to declare dividends (the income



actually having been previously distributed) would be to tax the petitioner because it could not accomplish the impossible;

(3) Such a tax would impose upon it a heavy penalty in relation to corporations which are relieved from restrictive contracts at more favorable times during the taxable year or happen to be on a favorable fiscal year basis—fortuitous circumstances completely disassociated from the actual tax situation here present; and

(4) Petitioner made payments during the first ten months of the year, *as required by the mortgage*, and if a retroactive effect were given to the release the benefit of the restrictive contract, in spite of its compulsory requirements which had been acted upon, would be withdrawn from taxpayer.

#### **Issue Under Section 26(c)(2) of the Revenue Act of 1936.**

The interpretation of Section 26(c)(2) also is governed, as taxpayer submits, by the principle, heretofore discussed, that a statute will be construed in accordance with the ordinary meaning of the words used, and, if possible, to avoid unjust and unreasonable consequences. In the discussion under this subdivision, it must be remembered that whether or not the sinking fund provisions of the mortgage be interpreted as dealing with earnings and profits, they were admittedly compulsory and binding upon the taxpayer, and the payments made were as required by the mortgage. Therefore, under subdivision (c)(1), in view of the stipulation, taxpayer was not only *prohibited from payment of dividends*, but was *required* to make payments under the mortgage as a condition precedent to a declaration of dividends, and until the release of the mortgage had insufficient funds either accumulated or accrued to make such payments (R. p. 11). However, it is most respectfully and earnestly contended that the sinking fund provision con-



stituted a disposition of earnings and profits within the meaning of Section 26(c)(2) of the Act. The mortgage required a tonnage payment for each ton of coal mined. The opinion of the Circuit Court of Appeals states that such was an agreement to pay a fixed sum, even though there were no earnings or profits, and even though the coal mined was not actually sold. The record, of course, shows that in the year in question there were gross sales in the amount of more than one million dollars (R. p. 19). Does this sinking fund provision imposing a current payment for each ton mined, deal with earnings or profits? Counsel confess that they are unable to grasp the significance of the distinction between *coal mined* and *coal sold*. While as a practical matter such would be impossible, suppose that taxpayer had mined its coal and had sold no part of it. *Its inventory of coal on hand would be increased and that increased inventory would go into its income statement.* Every corporation engaged in selling merchandise or products virtually always has income represented by increased inventory of products on hand, and if this taxpayer had large stocks of coal unsold, the increased inventory would go into its statement of earnings and profits, whether the product was actually sold or not.

Section 22(c) of the Revenue Act of 1936 (as well as corresponding provisions of other Acts) requires use of inventories whenever in the opinion of the Commissioner, such is necessary clearly to determine income, and taxpayer is within that provision and, *a fortiori*, would be bound by it if there were any considerable unmined coal at the end of a year. On page 5 of the return of taxpayer for the year in question, filed before the Board in this proceeding, appears an item of inventories in the amount of \$25,818.92, and while it is not broken down, it would be presumed to, and would necessarily include, unsold product on hand. As a matter of fact, counsel are informed by the

accountant of taxpayer, that such item does include unsold coal on hand, the value of which has always been reflected upon tax returns of taxpayer, although included in a general item of inventories. *Therefore, a tonnage payment for each ton of "coal mined" deals with earnings and profits to the same extent as if it were for each ton "mined and sold" because, if coal be not sold, its value goes into inventory, and is reflected in the income status, with precisely the same effect as if it had been sold.* As a practical matter, however, it would be impossible for a coal corporation to accumulate without selling any considerable stock of coal, and certainly "coal mined" as used in the mortgage would impute coal sold. Can it be imagined that a corporation would mine a large amount of coal and let it pile up on the ground, or that it could do so either from the physical or commercial viewpoint? The payments in the mortgage were tonnage payments, and as such were paid from the current sale of the coal that was mined, and such is also the inescapable legal conclusion. The only ground of distinction between the decision of the Circuit Court of Appeals (6th Circuit) in *Michigan Silica Co. v. Commissioner*, 124 F. (2d) 397, affirming per curiam the same entitled case, 41 B. T. A. 511, is that the sinking fund there was for a tonnage cement "produced and sold", while here the tonnage is only upon "coal mined". Unless that distinction be valid, there is an irreconcilable conflict between the decisions of the two Circuit Courts of Appeal. Certainly, such a distinction is not valid, because (a) if coal had been mined by taxpayer and not sold, its inventory would have been increased and that increased inventory would have gone into its statement of earnings and profits to the same effect as though there had been an actual sale; and (b) it would necessarily follow that by the mortgage the sale of the coal and not the mere production of the coal was contemplated, such being borne out by the sales during that

year of more than a million dollars. That this distinction was not recognized by the Board of Tax Appeals appears from the case of *Saginaw Manistee Lumber Co. v. Commissioner*, 45 B. T. A. 780, where a sinking fund provision for a unit payment upon lumber "sold or used" was held within the reasoning of the *Michigan Silica* case.

In this phase of the case, therefore, it is most respectfully submitted that the circumstance that the mortgage here provides for a tonnage payment upon "coal mined" does not differentiate it from the mortgage considered in the *Michigan Silica* case—the absence of specific reference to sale being immaterial for the reasons heretofore set forth, and there is accordingly an irreconcilable conflict in the decision in this case, and that of the Circuit Court of Appeals of the Sixth Circuit in the *Michigan Silica* case.

### Conclusion.

It is respectfully represented that this is a case in which the Court, in its sound judicial discretion, may appropriately grant the writ of certiorari as prayed, and that the petition and the brief in support thereof present special and important reasons therefor.

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# INDEX

	Page
Opinions below.....	1
Jurisdiction.....	1
Question presented.....	2
Statute and regulations involved.....	2
Statement.....	2
Argument.....	5
Conclusion.....	9
Appendix.....	10

## CITATIONS

### Cases:

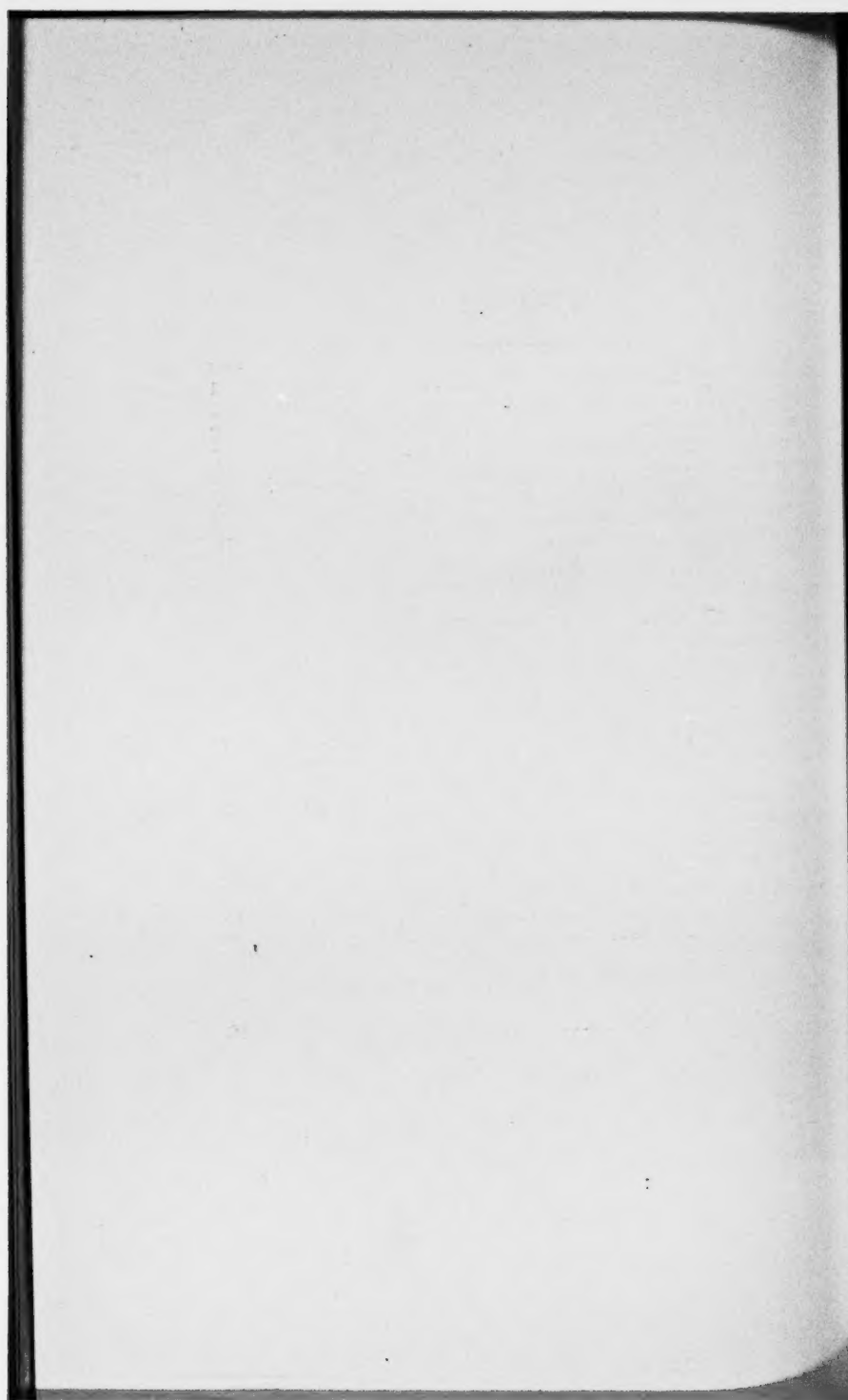
<i>Clark, C. C., Inc., v. United States</i> , 126 F. 2d 292.....	7
<i>Commissioner v. Dulup Oil Co.</i> , 126 F. 2d 1019.....	7
<i>Commissioner v. Michigan Silica Co.</i> , 41 B. T. A. 511, 124 F. 2d 397.....	8
<i>Commissioner v. Strong Mfg. Co.</i> , 124 F. 2d 360, reversed November 9, 1942.....	9
<i>Helvering v. Moloney Electric Co.</i> , 120 F. 2d 617, certiorari denied, 314 U. S. 682, rehearing denied, 315 U. S. 826.....	7
<i>Nevada-Massachusetts Co. v. Commissioner</i> , 128 F. 2d 347.....	7

### Statutes:

Revenue Act of 1926, c. 27, 44 Stat. 9:	
Sec. 22.....	8
Revenue Act of 1936, c. 690, 49 Stat. 1648:	
Sec. 14.....	10
Sec. 26.....	5, 6, 10

### Miscellaneous:

Treasury Regulations 94, promulgated under the Revenue Act of 1936:	
Art. 26-2.....	12



# In the Supreme Court of the United States

OCTOBER TERM, 1942

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No. 472

CLOVER SPLINT COAL CO., INC., PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL  
REVENUE

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*ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED  
STATES CIRCUIT COURT OF APPEALS FOR THE THIRD  
CIRCUIT*

---

**BRIEF FOR THE RESPONDENT IN OPPOSITION**

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**OPINIONS BELOW**

The opinion of the Board of Tax Appeals (R. 15-29) is not officially reported. The opinion of the Circuit Court of Appeals (R. 33-39) is reported at 130 F. 2d 52.

**JURISDICTION**

The judgment of the Circuit Court of Appeals was entered August 19, 1942. (R. 39.) Petition for a writ of certiorari was filed October 22, 1942. The jurisdiction of this Court is invoked under

Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

**QUESTION PRESENTED**

During the first ten months of 1937 the taxpayer was prohibited by contract from paying dividends within the meaning of Section 26 (c) of the Revenue Act of 1936. That prohibition was lifted on November 1, 1937. Is the taxpayer entitled to a credit under Section 26 (c) with respect to the income received during the first ten months?

**STATUTE AND REGULATIONS INVOLVED**

The statute and regulations involved appear in the Appendix, *infra*, pp. 10-14.

**STATEMENT**

This case involves petitioner's liability for undistributed profits taxes with respect to the year 1937. The facts, as stipulated (R. 3-14) and as found by the Board of Tax Appeals (R. 15-23), may be summarized as follows:

Taxpayer, a coal mining company, executed a mortgage to trustees as of May 1, 1929, to secure an issue of notes maturing May 1, 1936, in the aggregate amount of \$500,000. The mortgage provided that taxpayer should deposit with the corporate trustee twenty-five cents for each ton of coal mined so long as the aggregate amount of notes outstanding exceeded \$300,000, and twenty cents for each ton of coal mined when

the aggregate amount of notes outstanding was less than \$300,000. (R. 4-5.)

The mortgage was subsequently modified by three indentures executed as of April 10, 1931, August 1, 1932, and August 20, 1934, respectively, by the taxpayer, the noteholders and the trustees. Each modification relieved taxpayer of some of the more immediate of its obligations under its mortgage, the net effect of all the amendments being to extend the maturity of taxpayer's notes to May 1, 1941, to relieve taxpayer from making sinking fund payments for the period May 1, 1932, to November 1, 1936, and to postpone and defer the dates for paying interest on some of the taxpayer's outstanding notes. (R. 6-10, 21.) These modifications were conditioned upon various stipulations, those pertinent to the taxable year 1937 being as follows (R. 10, 11, 21):

The said party of the first part shall make no payments in the nature of dividends to its stockholders except it shall have previously paid to the Corporate Trustee an amount which would have been equal to the amount of sinking fund payments that would have been paid under and by virtue of said mortgage dated the first day of May, 1929, and said indenture dated the 10th day of April, 1931, or, at the election of said Clover Splint Coal Company, after it shall have required [acquired] notes secured by said mort-



gage in an amount equivalent to such amount of sinking fund requirements.

\* \* \* \*

The Clover Splint Coal Company shall make no payments in the nature of dividends to its stockholders, except that it shall have previously paid all interest coupons upon said outstanding notes accruing during the period aforesaid and interest upon said coupons as hereinafter set forth.

During the entire year 1936, and during the first ten months of 1937, taxpayer was not able to meet the foregoing conditions precedent to the payment of dividends. (R. 11, 22.)<sup>1</sup> However, on November 1, 1937, the noteholders exchanged their notes for an issue of taxpayer's Prior Preference stock, the mortgage was cancelled, and taxpayer was released from its covenants with respect to the payment of dividends. (R. 22.) Between November 1 and December 31, 1937, taxpayer paid dividends in the amount of \$2,812.50 out of earnings subsequent to November 1, 1937, for which the Commissioner allowed a dividends paid credit. (R. 23.)

Taxpayer's income for the calendar year 1937 was \$51,759.95, after the allowance for depletion. (R. 35.) During the first ten months of 1937 taxpayer paid the corporate trustee \$98,204.77, which

<sup>1</sup> At the beginning of 1937, taxpayer had a deficit in the amount of \$435,614.86. (R. 23.)

was employed by the trustee, pursuant to the mortgage covenants, for the retirement of some of the notes and for the payment of interest upon the notes up to November 1, 1937. (R. 22-23.)

The Board of Tax Appeals held that taxpayer in computing its undistributed net income for the calendar year 1937, for the purposes of the surtax on its undistributed profits, was not entitled under Section 26 (c) to a credit in the amount of its income for the first ten months of the year 1937 and, accordingly, sustained the tax determined by the Commissioner against the taxpayer's undistributed net income for the year 1937. (R. 29.) The Circuit Court of Appeals affirmed the Board. (R. 39.)

#### ARGUMENT

1. The sole question under Section 26 (c) (1) of the Revenue Act of 1936 (Appendix, *infra*) is whether taxpayer could have distributed a sum equal to its adjusted 1937 net income, within the year, as dividends without violating a provision of a written contract executed prior to May 1, 1936, which provision "expressly deals with the payment of dividends". This, taxpayer plainly could do after November 1, 1937, and the Board of Tax Appeals and the Circuit Court of Appeals properly so held. It may be assumed that if the mortgage with its accompanying covenants had continued in existence throughout the calendar year 1937, the taxpayer would be entitled to the credit which it seeks. But the covenants were ex-

tinguished on November 1, 1937; during the remaining two months, therefore, it was free to distribute all of its 1937 earnings as dividends to its stockholders. Taxpayer contends, however, that its earnings for the first ten months had already been exhausted, so that the statute could operate only upon the earnings of the last two months. But there is nothing in the record to show that the \$98,204.77 paid to the trustee during the first ten months must be charged against the earnings for that period. For aught that appears the earnings remained intact and available for distribution after November 1, 1937. In these circumstances the court below did not err in holding Section 26 (c) (1) inapplicable.

2. Nor is taxpayer entitled to the credit claimed under Section 26 (c) (2). Taxpayer was obligated to pay interest on its secured notes at the stipulated rate, whether or not it had earnings or profits. But its contractual obligation to pay interest did not "expressly" deal with "the disposition of [its] earnings and profits of the taxable year" and require *them* to be paid in discharge of or to be irrevocably set aside within the taxable year for the discharge of the interest. Indeed, taxpayer does not make such a contention here.

So, too, taxpayer's obligation to make sinking fund payments to the trustee, at a certain rate per ton for each ton of coal mined, was an obligation entirely without reference to earnings or profits

during the year, and operated though taxpayer might have no earnings or profits during the year, and whether or not the taxpayer sold any coal whatever that year. Taxpayer's obligation for these payments was conditioned solely upon tonnage production. Thus it did not expressly deal with "the disposition of [taxpayer's] earnings and profits of the taxable year" 1937, and it did not by express provision require earnings and profits "to be paid within the taxable year in discharge \* \* \* or to be irrevocably set aside within the taxable year for the discharge of a debt". *Helvering v. Moloney Electric Co.*, 120 F. 2d 617 (C. C. A. 8th), certiorari denied, 314 U. S. 682, rehearing denied, 315 U. S. 826; *Commissioner v. Dulup Oil Co.*, 126 F. 2d 1019 (C. C. A. 5th). See also *C. C. Clarke, Inc. v. United States*, 126 F. 2d 292 (C. C. A. 5th); *Nevada-Massachusetts Co. v. Commissioner*, 128 F. 2d 347 (C. C. A. 9th).

To taxpayer's final argument—in substance that its mortgage by implication deals with the disposition of its earnings and profits of the taxable year—it suffices to answer that Section 26 (c) (2) requires, as a condition to any credit, that the contract provision "expressly deal" with the disposition of the year's earnings and profits. This the taxpayer's mortgage did not do, and the Circuit Court of Appeals so noted, saying (R. 38-39):

"The mortgage indenture upon which the taxpayer here relies does not \* \* \* expressly or by implication deal with the disposition of earnings and profits."<sup>2</sup>

There is no conflict with *Commissioner v. Michigan Silica Co.*, 124 F. 2d 397 (C. C. A. 6th). The Silica Company's engagement, as shown by the finding and opinion of the Board of Tax Appeals (41 B. T. A. 511), was to pay for sinking fund purposes to its trustee, by the tenth of each month, 25 cents "for each ton of sand produced and sold" by it during the preceding month (p. 513). The Board thought (pp. 514-515) that the trust indenture dealt expressly with the disposition of earnings and profits of the taxable year "since the amounts which were required to be paid into the sinking fund in the taxable year were based upon the receipts of the petitioner from the sale of its sand". But whatever may be said of the correctness of that ruling, it is inapplicable here; for payments into the sinking fund in this case were to be measured by production irrespective of whether there were any gross receipts. Moreover, the present status of the *Michigan Silica Co.* case is open to serious doubt: it had been decided *per*

<sup>2</sup> In support of its implication argument taxpayer represents (Pet. 11, Br. 27-28) that its income tax liability for the year 1937 has been and is determined by the use of coal inventories. (See Section 22 (c) Revenue Act of 1926.) The record, as we view it, does not justify any such conclusion of fact, particularly in an appellate court.

*curiam* on authority of *Commissioner v. Strong Mfg. Co.*, 124 F. 2d 360 (C. C. A. 6th), decided the same day, which was subsequently reversed by this Court, November 9, 1942, No. 41, present Term.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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NOVEMBER 1942.

## APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

### SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) *Definitions.*—As used in this title—

(1) The term “adjusted net income” means the net income minus the sum of—

\* \* \* \*

(2) The term “undistributed net income” means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) *Imposition of Tax.*—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

\* \* \* \*

### SEC. 26. CREDITS OF CORPORATIONS.

In the case of a corporation the following credits shall be allowed to the extent provided in the various sections imposing tax—

\* \* \* \*



(c) *Contracts Restricting Payment of Dividends.*—

(1) *Prohibition on Payment of Dividends.*—An amount equal to the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the payment of dividends. If a corporation would be entitled to a credit under this paragraph because of a contract provision and also to one or more credits because of other contract provisions, only the largest of such credits shall be allowed, and for such purpose if two or more credits are equal in amount only one shall be taken into account.

(2) *Disposition of Profits of Taxable Year.*—An amount equal to the portion of the earnings and profits of the taxable year which is required (by a provision of a written contract executed by the corporation prior to May 1, 1936, which provision expressly deals with the disposition of earnings and profits of the taxable year) to be paid within the taxable year in discharge of a debt, or to be irrevocably set aside within the taxable year for the discharge of a debt; to the extent that such amount has been so paid or set aside. For the purposes of this paragraph, a requirement to pay or set aside an amount equal to a percentage of earnings and profits shall be considered a requirement to pay or set aside such percentage of earnings and profits. As used in this paragraph, the word "debt" does not include a debt incurred after April 30, 1936.

\* \* \* \* \*

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 26-2. *Credit in connection with contracts restricting payment of dividends.*—

(a) The credit provided in section 26 (c) with respect to contracts restricting the payment of dividends is not available under every contract which might operate to restrict the payment of dividends, but only with respect to those provisions of written contracts executed by the corporation prior to May 1, 1936, which satisfy the conditions prescribed in the Act. The charter of a corporation does not constitute a written contract executed by the corporation within the meaning of section 26 (c). The provisions recognized by the Act are of two general types, as follows:

(1) Those which come within section 26 (c) (1), in that they prohibit or limit the payment of dividends during the taxable year; and

(2) Those which come within section 26 (c) (2), in that they require the payment, or irrevocable setting aside, within the taxable year, of a specified portion of the earnings or profits of the taxable year for the discharge of a debt incurred on or before April 30, 1936.

\* \* \* \* \*

(b) *Prohibition on payment of dividends.*—The credit provided in section 26 (c) (1) is allowable only with respect to a written contract executed by the corporation prior to May 1, 1936, which expressly deals with the payment of dividends and operates as a legal restriction upon the corporation as to the amounts which it can distribute within the taxable year as dividends.

If an amount can be distributed within the taxable year as a dividend—

(1) in one form (as, for example, in stock or bonds of the corporation) without violating the provisions of a contract, but can not be distributed within the taxable year as a dividend in another form (as, for example, in cash) without violating such provisions, or

(2) at one time (as, for example, during the last half of the taxable year) without violating the provisions of a contract, but can not be distributed as a dividend at another time within the taxable year (as, for example, during the first half of the taxable year) without violating such provision—

then the amount is one which, under section 26 (c) (1), can be distributed within the taxable year as a dividend without violating such provisions.

The credit provided in section 26 (c) (1) is equal to the excess of the adjusted net income, as defined in section 14 (a), over the aggregate of the amounts which can be distributed within the taxable year without violating the provisions of such contract. The requirement that the provisions of the contract expressly deal with the payment of dividends is not met in case (1) a corporation is merely required to set aside periodically a sum to retire its bonds, or (2) the contract merely provides that while its bonds are outstanding the current assets shall not be reduced below a specified amount.

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(c) *Disposition of profits of taxable year.*—Under the provisions of section 26 (c) (2), a corporation is allowed a credit in an amount equal to that portion of the

earnings and profits of the taxable year which, by the terms of a written contract executed by the corporation prior to May 1, 1936, and expressly dealing with the disposition of the earnings and profits of the taxable year, it is required within the taxable year to pay in, or irrevocably to set aside for, the discharge of a debt incurred on or before April 30, 1936. The credit is limited to that amount which is actually so paid or irrevocably set aside during the taxable year pursuant to the requirements of such a contract.

Only a contractual provision which expressly deals with the disposition of the earnings and profits of the taxable year shall be recognized as a basis for the credit provided in section 26 (c) (2). A corporation having outstanding bonds is not entitled to a credit under a provision merely requiring it, for example, (1) to retire annually a certain percentage or amount of such bonds, (2) to maintain a sinking fund sufficient to retire all or a certain percentage of such bonds by maturity, (3) to pay into a sinking fund for the retirement of such bonds a specified amount per thousand feet of timber cut or per ton of coal mined, or (4) to pay into a sinking fund for the retirement of such bonds an amount equal to a certain percentage of gross sales or gross income. Such provisions do not expressly deal with the disposition of earnings and profits of the taxable year. \* \* \*

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